The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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Fifth Circuit Vacates SEC's Private Fund Adviser Rule

[35758]

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TO: ICI Members
Investment Company Directors
Broker/Dealer Advisory Committee
Chief Compliance Officer Committee
CIT Advisory Committee
Investment Adviser and Broker-Dealer Standards of Conduct Working Group
Investment Advisers Committee
Retail SMA Advisory Committee
SEC Rules Committee SUBJECTS: Compliance
Investment Advisers RE: Fifth Circuit Vacates SEC's Private Fund Adviser Rule

On June 5th, 2024, a three-judge panel of the United States Fifth Circuit Court of Appeals issued a unanimous decision to vacate the SEC's Private Fund Adviser Rule in its entirety on the grounds that the Commission lacked statutory authority to adopt the rule.[1] Compliance with the Private Fund Adviser Rule would have completely overhauled the private fund industry and fundamentally changed the way private fund managers conduct their businesses. The Private Fund Adviser Rule was challenged by a group of six private fund industry groups ("petitioners"). Siding with the petitioners, the Fifth Circuit held that the Commission's "promulgation of the [Private Fund Adviser Rule] was unauthorized" and that "no part of [the Private Fund Adviser Rule] can stand."[2] Moving forward it is unclear whether the SEC will appeal this decision. As issued, the Opinion has significant implications for pending SEC proposals, as well as previous rules the Commission has promulgated, that rely on the same statutory authority.

Background on the Litigation

The Commission adopted the Private Fund Adviser Rule on August 23, 2023 and imposed regulations that would have created substantial new compliance obligations for private fund advisers. These regulations, among other things, would have imposed new disclosure, consent and reporting requirements, an annual audit requirement and prohibitions relating to granting preferential treatment for private funds. On September 1, 2023, petitioners challenged the Private Fund Adviser Rule in the Fifth Circuit. Seeking to invalidate the Private Fund Adviser Rule, petitioners claimed: (1) the Commission exceeded its statutory

authority, (2) the Private Fund Adviser Rule is not a logical outgrowth of the Proposed Rule, (3) the Private Fund Adviser Rule is arbitrary and capricious under the Administrative Procedure Act, and (4) the Commission failed to adequately consider the Private Fund Adviser Rule's impact on efficiency, competition, and capital formation.[3]

The central arguments focused on statutory authority and whether the Commission had authority to issue the Private Fund Adviser Rule under Sections 206(4) and 211(h) of the Advisers Act. The Commission argued it had the authority to promulgate the Private Fund Adviser Rule under Sections 206(4) and 211(h). The Fifth Circuit found that "neither section grants the Commission such authority,"[4] asserting that the statutory language and legislative intent did not support the Commission's expansive regulatory authority.

Summary of the Opinion

In making its determination, the Fifth Circuit first provided context for its decision. The Opinion begins with a general background of private funds and their recent growth. Then, notably, the analysis turns to Congress's intent not to regulate private funds under the Investment Company Act of 1940 ("1940 Act"). The Opinion discusses registered investment companies and their extensive regulation under the 1940 Act, emphasizing that the 1940 Act and the Advisers Act are "sister statutes" that Congress enacted "simultaneously" as two parts of the same legislation.[5] The court then cites to Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006), noting that with respect to the fiduciary duty owed to clients under the Advisers Act, "[i]n the private fund context, that client is the fund itself—not the fund's investors."[6]

The Opinion next discusses the statutory background of Sections 206(4) and 211(h) of the Advisers Act, which are the basis for the Commission's authority in promulgating the Private Fund Adviser Rule and then follows with its analysis.

211(h)

In formulating the Private Fund Adviser Rule, the SEC relied heavily on Dodd-Frank,[7] arguing that the Dodd-Frank Act fills a "serious statutory gap" and that it authorized the Commission "to issue rules 'for the protection of investors' concerning certain disclosures, sales practices, conflicts of interest, and compensation schemes."[8] The Commission argued that use of the term "investors" in Section 211(h) granted it with the authority to regulate interactions between private funds advisers and their investors. In contrast, the petitioners argued that "Congress drew a 'sharp line' between private funds and funds that serve retail customers,"[9] and that the Dodd-Frank Act did not provide the Commission the authority to broadly regulate private funds or their sophisticated investors.

The Fifth Circuit disagreed with the Commission. The court held that 211(h) only applies to "retail customers" and does not provide authority for the adoption of the Private Fund Adviser Rule. In analyzing the breadth of Section 211(h) and Congress's intent, the court found that "statutory language 'cannot be construed in a vacuum. It is a fundamental canon of statutory construction that the words of a statute must be read in their context and with a view to their place in the overall statutory scheme.'"[10] Referring back to the categorization of the 1940 Act and Advisers Act as "sister statues" and citing to Goldstein, the court emphasized that "Congress clearly chose not to impose the same prescriptive framework [of the 1940 Act] on private funds."[11]

Along those same lines, the Fifth Circuit discussed background of Section 211(h), noting that Congress enacted it in 2010 as part of Section 913 of the Dodd-Frank Act. The court emphasized that Section 913(h) concerns the standard of conduct that should be applied to

"retail customers." As the court explained, Congress' intent, in using the term "customer" in Section 913 of the Dodd-Frank Act, was to apply all the sub-sections of Section 913 only to "retail customers," not private fund investors, as "[Section 913] has nothing to do with private funds."[12] The court observed that, while Section 913(h) refers to "investors," that "[i]t is unlikely that Congress meant to switch to 'investor' 'in the middle of a provision otherwise devoted' to retail investment."[13] As support for its interpretation of Section 913, the court highlighted Title IV of the Dodd-Frank Act in which Congress enacted provisions clearly intended to regulate private fund advisers. By contrast, Section 913 is focused on "retail customers."[14]

206(4)

The Commission also relied on its antifraud rulemaking authority in Section 206(4) of the Advisers Act to adopt the Private Fund Adviser Rule.[15] The Commission argued that it had authority to adopt the Private Fund Adviser Rule to prevent fraudulent acts by private fund advisers because, "it may regulate acts that are 'not themselves fraudulent' if the restriction is 'reasonably designed to prevent' fraud or deception."[16] On the other hand, the petitioners claimed that the Commission had not articulated a "rational connection" or "close nexus" between fraud and any part of the Private Fund Adviser Rule.[17]

The Fifth Circuit found that "[t]he Commission cannot rely on section 206(4) for the authority to adopt the [Private Fund Adviser Rule]."[18] The Fifth Circuit agreed with the petitioners' argument that the Commission fails to articulate a 'rational connection' between fraud and the Private Fund Adviser Rule. Significantly, the court found that, "the Commission fails to explain how the [Private Fund Adviser Rule] would prevent fraud," finding that Section 206(4) "specifically requires the Commission to 'define' an act, practice, or course of business that is 'fraudulent, deceptive, or manipulative' before the Commission can prescribe 'means reasonably designed to prevent' 'such' act, practice, or course of business."[19]

Further, the court reasoned that Section 206(4) fails to authorize the Commission to require disclosure and reporting and that while the Commission "conflates a 'lack of disclosure' with 'fraud' or 'deception,' . . . a failure to disclose 'cannot be deceptive' without a 'duty to disclose.'"[20] The Fifth Circuit additionally explains that certain sections of the Advisers Act expressly require reporting and disclosure whereas Section 206(4) does not.

Impacts of the Decision

At present time, it is still uncertain what the Commission's next steps will be regarding the Fifth Circuit's decision. Going forward, the Commission has several options. The Commission could petition the same Fifth Circuit panel or the Fifth Circuit in its entirety to hear the case en banc. Alternatively, the Commission could file a petition for certiorari seeking review before the United States Supreme Court.

Regardless, this decision will likely have considerable implications for the SEC's regulatory approach. The statutory basis the Commission relied on to adopt the Private Fund Adviser Rule is the same authority used as the basis for several pending proposals, as well as rules that have been finalized. This includes the following rule proposals: the Predictive Data Analytics Rules, the Safeguarding Rule, the Cybersecurity Rule and the Outsourcing Rule. Adopted rules that may be vulnerable to challenge include: the Marketing Rule, the Proxy Voting Rule and the Compliance Rule.[21] At the very least, it is likely the SEC will closely evaluate its authority for these pending proposals.

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Notes

[1] National Association of Private Fund Managers v. Securities and Exchange Commission, 5th Cir. No. 23-60471 (hereinafter, the "Opinion"). The Private Fund Adviser Rules include the following rules under the Investment Advisers Act of 1940 ("Advisers Act"): Rule 206(4)-10, Rule 211(h)(1)-2, Rule 211(h)(2)-1, Rule 211(h)(2)-2 and Rule 211(h)(2)-3. Although there are five separately numbered Private Fund Adviser Rules, the Opinion treats the Private Fund Adviser Rules as a single "Private Fund Adviser Rule." The Fifth Circuit Opinion may be found here: https://www.ca5.uscourts.gov/opinions/pub/23/23-60471CV0.pdf.

[2] See Opinion at 25.

[3] Id. at 14-15. The Opinion did not address the other issues raised by the petitioners. The Opinion briefly discusses the issues of venue and standing. The Commission had challenged the petitioners' Article III standing and argued that the venue was not proper. The court found that the petitioners did have standing.

[4] Id. at 18.

[5] Id. at 4.

[6] Id. at 4-5.

[7] Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376 (2010)(the "Dodd-Frank Act"). Section 913(h) of the Dodd-Frank Act is codified at Section 211(h) of the Advisers Act.

[8] See Opinion at 17.

[9] Id.

[10] Id. at 19, citing Roberts v. Sea-Land Servs., Inc., 566 U.S. 93, 101 (2012) (citation omitted).

[11] Id. at 20.

[12] Id. at 21.

[13] Id. at 22.

[14] Id. at 10 and 21.

[15] Section 206(4) of the Advisers Act authorizes the SEC to "define, and prescribe means reasonably designed to prevent, such acts, practices, and course of business as are fraudulent, deceptive, or manipulative."

[16] See Opinion at 22.

[17] Id. at 23.

[18] Id. at 25.

[19] Id.

[20] Id. at 23-24.

[21] While it may be too late for a plaintiff to bring a case directly challenging the Commission's authority for these rules, some of which were adopted years ago, it is possible that lack of authority could be asserted as a defense in an enforcement action brough under one of these rules.
